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# Individual Retirement Savings Plans: A Mixed Blessing Conferred by ERISA

Carol M. Lambert  
*University of Kentucky*

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# INDIVIDUAL RETIREMENT SAVINGS PLANS: A MIXED BLESSING CONFERRED BY ERISA

## I. INTRODUCTION

In response to widespread adverse publicity concerning private pensions<sup>1</sup> President Kennedy appointed the Private Pension Study Committee in 1962.<sup>2</sup> This Committee concluded that the system then existing was highly inequitable and that millions of workers were not covered by any kind of pension plan at all.<sup>3</sup> Subsequent congressional committees examined the problem and suggested possible remedies<sup>4</sup> as did the Nixon Administration.<sup>5</sup> The ultimate result was the passage of the Employees Retirement Income Security Act of 1974 (ERISA).<sup>6</sup>

Although most of this Act deals with the existing pension system, it also creates a new system: the Individual Retirement Savings Plan (IRSP).<sup>7</sup> This plan establishes a way for millions

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<sup>1</sup> *E.g.*, *McCotis v. Nashua Pressmen Union*, 248 A.2d 85 (N.H. 1968), *discussed in Comment, The Employee Retirement Income Security Act of 1974: Policies and Problems*, 26 SYRACUSE L. REV. 539, 565 (1975).

<sup>2</sup> Childs, *1974 Pension Reform Law Treatment of Participation, Coverage and Distributions*, 52 TAXES 864 (1974). *See also Comment, supra* note 1.

<sup>3</sup> Only 50 percent of the work force was covered by pension and profit-sharing benefits in 1972, a statistic that has remained relatively constant since the late 1960s. AMERICAN BANKING ASS'N, *A GUIDE TO INDIVIDUAL RETIREMENT ACCOUNTS* 22 (1975). This 50 percent includes disproportionately high numbers of lower-paid workers, women, and minorities. Pensions are common in big business and heavily unionized industry, but few employees in small business, farms and fisheries enjoy coverage. Hall, *Individual Retirement Accounts*, in *Symposium, New Developments in Tax Administration and Pension Plans*, 27 NAT'L TAX J. 459 (1974).

<sup>4</sup> In 1963 pension reform activity increased, especially in the Senate, where the Labor and Finance Committees laid claims to jurisdiction that ultimately gave rise to the dual Labor-Treasury responsibility under the Act. In 1974, five pension bills were passed by the tax and labor committees, culminating in H.R. 2 which both houses adopted. After the bill was rewritten by a conference committee, it was passed by both houses and signed by President Ford on Labor Day, Sept. 2, 1974. Childs, *supra* note 2.

<sup>5</sup> The Treasury Department originated one of the few Administration contributions to the Pension Reform Act, the Individual Retirement Account (IRA). In recommending the IRA, the Administration looked to a successful Canadian experience, where similar tax-deferred retirement accounts have existed for several years. Canadian tax law provides for ordinary qualified pension plans, but has nothing comparable to Keogh Plans; for this reason Canada's IRA's are used by individuals as well as partners and employees of a partnership. Hall, *supra* note 3. *See also* AMERICAN BANKING ASS'N., *supra* note 3.

<sup>6</sup> In its original form, ERISA appeared as P.L. 93-406, 93rd Cong., 88 Stat. 829.

<sup>7</sup> For an excellent explanation of Individual Retirement Savings Plans (IRSP),

of workers not previously covered by qualified<sup>8</sup> or Keogh Plans<sup>9</sup> to set up their own pension plan by selecting one of three statutory options: the Individual Retirement Account, the Individual Retirement Annuity, or the Individual Retirement Bond. Because the Act's provisions covering the preexisting pension system have already received a great deal of attention, this note will focus on the new possibilities created by the Act.

## II. PROVISIONS AFFECTING ALL THREE OPTIONS

### A. *Participants*

In order to establish a qualified IRSP a worker may not be an active participant in a qualified retirement plan or a qualified bond pension plan.<sup>10</sup> The problem, however, is defining "active participant" since an individual cannot set up an IRSP

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see INTERNAL REVENUE SERVICE, PUBLICATION NO. 590 TAX INFORMATION ON INDIVIDUAL RETIREMENT SAVINGS PROGRAMS (April 1975). The basic INT. REV. CODE OF 1954 [hereinafter cited as IRC] sections establishing the IRSP package are IRC § 219 which authorizes tax deductible contributions to all three options within the IRSP package; IRC § 220 which authorizes IRSP's for homemakers; § 408 which discusses individual retirement accounts and individual retirement annuities; and IRC § 409 which discusses individual retirement bonds.

<sup>8</sup> "Qualified" pension plans are those plans which have qualified for the favorable tax treatment granted in IRC §§ 501, 402, 403(a), 405(a), 406, 407. If the plan meets the statutory requirements of IRC § 401 the employer can deduct his contribution as a business expense, even though the employee need not include it in gross income.

<sup>9</sup> Keogh (H.R. 10) Plans, named after the representative who introduced the bill in Congress, are actually a predecessor of Individual Retirement Savings Plans in that they provide a means for a self-employed individual to set up his own pension plan and to deduct the contributions made to it. Since any worker not covered by a qualified plan can set up an Individual Retirement Savings Plan, self-employed workers must now choose between these two types of plans.

<sup>10</sup> IRC § 219(b)(2). The proposed Tax Reform Act of 1975-76 (House version), H.R. 10612, 94th Cong., 1st Sess. Title XV § 1502(a)(1975) adding new IRC § 220(b)(1) would have allowed a participant in a qualified plan to establish an IRSP and fund it by tax-deductible contributions not exceeding:

(A) the lesser of 15 percent of the compensation includible in his gross income for such taxable year or \$1,500, reduced by

(B) the qualifying employer contributions for such taxable year.

The House version, however, still excluded participants in government plans. In contrast, the Senate version of H.R. 10612, at Title XV § 1503 adding new IRC § 220 for government employees generally and § 1504 adding new IRC § 219 for reservists and national guards, also expanded IRSP coverage to participants in government plans including national guardsmen and reservists.

The House version authorizing participants in qualified plans to establish IRSP's to supplement their qualified plan benefits was not adopted in the final version of the 1976 Tax Reform Act. Congress did, however, require the Joint Committee on Taxation

if at any time during the year he was an "active participant" in a pension plan established under the Internal Revenue Code of 1954 (IRC) § 401, an annuity plan under IRC § 403(a) or (b), a qualified bond plan established under IRC § 405(a), or a retirement plan established by a state or by the federal government.<sup>11</sup>

While the statute does not define "active participant," a definition is found in the proposed Treasury Regulations. An individual is an "active participant" in a qualified plan if at any time during the year benefits accrued under the plan on the individual's behalf, an employer was obligated to contribute to or under the plan on the individual's behalf, or the employer would have been obligated to contribute to or under the plan on the individual's behalf if *any* contributions were made to or under the plan.<sup>12</sup> Moreover, an individual to whom one of these provisions applies is a participant even if his right to benefits has not yet vested, *i.e.* it is forfeitable.<sup>13</sup>

An individual is not an "active participant," however, if there was no contribution to a qualified plan during the indi-

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to study the possibility of expanding IRSP coverage to include participants in qualified private pension, profit-sharing, and stock bonus plans established by private employers and participants in similar plans established by governmental entities. See Tax Reform Act of 1976, Pub. L. No. 94-455 § 1509 [hereinafter cited as 1976 Tax Reform Act].

The Senate version expanding IRSP coverage to National Guardsmen and Reservists was enacted, however. Under the Act, for taxable years beginning after 1975, such individuals will be permitted to participate in IRSP's and fund them with tax deductible contributions under IRC § 219 unless they have served on active duty (other than days on active duty for training) in excess of 90 days during the taxable year. Also, for taxable years beginning after 1976, such individuals can establish IRSP's for their nonworking spouses and fund them with tax deductible contributions under IRC § 220. See IRC §§ 219(c)(4), 220(c)(5).

Also, for taxable years beginning after 1975, volunteer firemen who otherwise qualify may establish IRSP's and fund them with tax deductible contributions under the above sections even though they are covered by a qualified plan. The individual fireman's accrued benefit under such a plan, however, must not, at the beginning of the taxable year, exceed \$1,800 (when expressed as a single life annuity beginning at age 65). See IRC § 219(c)(4)(B). CCH Explanation, CCH STAND. FED. TAX REP., Tax Reform Act of 1976 ¶ 506.

<sup>11</sup> *Id.* This prohibition does not apply to reservists, national guardsmen, and volunteer firemen.

<sup>12</sup> Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(A), 40 Fed. Reg. 7662, (1975). As of March, 1976, the final regulations had not yet been issued.

<sup>13</sup> *Id.* See also 3 CCH 1976 STAND. FED. TAX REP. ¶ 2663.05. House Ways and Means Committee, General Explanation.

vidual's tax year and if contributions have been completely discontinued.<sup>14</sup> In addition, one is not an "active participant" for a prior tax year just because he is given past service credit in the plan.<sup>15</sup> This eliminates the possibility of losing prior deductions because of subsequent actions. Nor will he be an "active participant" during any period of separation from service covered by the plan, even though his right to benefits accrued during this period was unforfeitable.<sup>16</sup> Finally, the service will not consider an individual an "active participant" in any year he chose not to participate in the plan.<sup>17</sup>

Also, an individual may establish his own plan under IRC § 219 when his employer does not offer a tax-sheltered retirement plan. If, at a later date, the employer establishes a qualified plan and the individual elects to participate, he may be given retroactive credit for service prior to establishment of the qualified plan. If this occurs, the individual may receive a double tax break. Because he was not an active participant for the years of prior service, contributions made during those years to his own IRSP remain in effect even though he later elects to participate in the qualified plan. This election will only prohibit future contributions to his IRSP while the individual is participating in the qualified plan. In addition, the IRSP continues to exist and collect tax-free interest until distribution or rollover.<sup>18</sup>

An individual, however, may be considered an active participant for those years he elected not to be covered by an existing qualified plan if he later changes his mind and elects such coverage. This is true if the plan has provisions under which he can purchase retroactive benefits based on the time in which he could have elected coverage. Here the individual is treated as an active participant during each prior year for which such coverage is obtained.<sup>19</sup> Just because the individual

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<sup>14</sup> Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(A), 40 Fed. Reg. 7662 (1975).

<sup>15</sup> Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(B), 40 Fed. Reg. 7662 (1975).

<sup>16</sup> Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(A), 40 Fed. Reg. 7662 (1975).

<sup>17</sup> IRC § 219(b)(2).

<sup>18</sup> Proposed Treas. Reg. § 1.219-1(c)(1)(ii)(B), 40 Fed. Reg. 7662 (1975). For a discussion of rollovers see text accompanying notes 31 to 54 *infra*. See also Stevenson, *The New Individual Retirement Accounts: What They Are and How They Operate*, 40 J. OF TAXATION 91 (1975). See also Fisher & Berger, *A New Tax Benefit—Individual Retirement Plans Under the '74 Act*, 6 TAX ADVISOR 215, 216 (1975).

<sup>19</sup> Proposed Treas. Reg. § 1.219-1(c)(1)(ii), 40 Fed. Reg. 7662 (1975). See also

was not an active participant in a qualified plan, however, does not mean he is eligible for the Individual Retirement Savings Plan. He must also be a wage earner<sup>20</sup> under the age of 70½.<sup>21</sup>

## B. Contributions

An IRSP participant can deduct up to "15 percent of compensation includible in his gross income for such taxable year, or \$1,500, whichever is less."<sup>22</sup> Voluntary nondeductible contributions above this ceiling are effectively prohibited by the excess contribution excise tax.<sup>23</sup>

Again a crucial element to the application of this section is definitional. The proposed regulations define "compensation" as:

wages, salaries, or professional fees, and other amounts received for personal services actually rendered (including, but not limited to, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, and bonuses) and includes earned income, as defined in section 401(c)(2), [self-

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Fisher & Berger, *supra* note 18, at 216.

<sup>20</sup> The proposed Tax Reform Act of 1975-76 as reported by the Senate Finance Committee, H.R. 10612, 94th Cong., 1st Sess. at Title XV § 1501(a) *redesignating* (House) IRC § 221 as § 222 and *adding* new (Senate) IRC § 221 modified the present requirement that one be a wage earner to establish an IRSP.

In S. Rep. No. 94-938, 94th Cong., 2d Sess. 445 (1976) the Senate Finance Committee asserted that the wage earner requirement is "unfair to a spouse who receives no compensation but performs valuable household work." Thus, the committee added a provision to H.R. 10612, which would permit an employee to set aside retirement savings for the benefit of a spouse not working outside the home.

IRSP's for homemakers were incorporated into the final version of the 1976 Tax Reform Act as IRC § 220. Effective for taxable years beginning after 1976, an individual can establish an IRSP for his nonworking spouse and fund it with tax deductible contributions. The deduction, however, is more limited than that allowed for a married couple where both spouses are working.

Under IRC § 220 the total allowable deduction for IRSP's covering both working and nonworking spouses is the smallest of:

- (a) 15% of the compensation includible in the working spouse's income for the taxable year,
- (b) \$1,750, or
- (c) twice the amount contributed to the individual retirement arrangement of the spouse for whose benefit the smaller amount was contributed.

<sup>21</sup> IRC § 219(b)(1).

<sup>22</sup> *Id.* Of course, if the taxpayer contributes less than he is entitled to contribute, he can deduct only this amount. PUBLICATION No. 590, *supra* note 7, at 1.

<sup>23</sup> See text accompanying notes 59 to 69 *infra*.

employment] but compensation does *not* include amounts received as earnings or profits from property (including but not limited to, interest and dividends) or amounts not includible in gross income such as income from sources without the United States excluded from gross income under section 911.<sup>24</sup>

Thus, the individual must deduct his passive income from gross income to determine the permitted deduction. This deduction is applied against gross income and the taxpayer is eligible for it even though the standard deduction is elected; one need not itemize to enjoy this deduction.<sup>25</sup> The effect of this action is tax deferment until actual distribution of the IRSP's assets, for in addition to the contributions being deductible, the earnings are also tax-free until distribution.<sup>26</sup> In addition, certain IRSP's allow a double tax break. If both spouses work and are not covered by a qualified private, government, or Keogh Plan, they can each establish an IRSP, file a joint return, and enjoy a deduction of the lesser of \$3,000 or 15 percent of the total compensation received by both spouses.<sup>27</sup>

Upon distribution, the amounts received under the plan are taxed as ordinary income. Capital gain treatment is not available, and the special 10 year income averaging rule for

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<sup>24</sup> Proposed Treas. Reg. § 1.219-1(c)(i), 40 Fed. Reg. 7662 (1975).

<sup>25</sup> CCH Explanation, 2 1976 CCH STAND. FED. TAX REP. ¶ 2061.

<sup>26</sup> Proposed Treas. Reg. § 1.408-1(1), 40 Fed. Reg. 7666 (1975). This regulation covers individual retirement accounts and annuities. Although IRC § 409 and its accompanying regulations are silent on this point, PUBLICATION No. 590, *supra* note 7, at 1, indicates that the official IRS position is that income earned by bonds is tax-free until distribution. See CCH Explanation, CCH STAND. FED. TAX REP. Tax Reform Act of 1976 ¶ 503. No deduction is allowed for the taxable year during which either spouse attains the age 70 ½.

The Act does not provide any new funding media for the IRSP's covering the nonworking spouse. Joint ownership of the funding medium is prohibited, but one IRSP with separate subaccounts for each spouse with right of survivorship to the subaccount of the other is permissible. See CONFERENCE COMM. ON THE TAX REFORM ACT of 1976, S. REP. No. 94-1236, 94th Cong., 2d Sess. 445 (1976) [hereinafter cited as CONFERENCE REPORT].

Qualified and government plan participants are barred from participation in IRSP's under IRC § 220. This prohibition also extends to individuals who used section 219 to obtain IRSP tax benefits.

<sup>27</sup> Proposed Treas. Reg. § 1.219-1(c)(2), 40 Fed. Reg. 7663 (1975). Both spouses, however, must work; community property laws giving each spouse a 50 percent interest will *not* operate to give the nonworking spouse an opportunity to set up a tax deductible IRSP. *Id.*

lump sum distributions from qualified plans does not apply.<sup>28</sup> The taxpayer can use, however, the 5 year income averaging provisions available to everyone.<sup>29</sup> Moreover, for purposes of the retirement income credit, the amounts received by retirees from IRA's and annuities are retirement income.<sup>30</sup>

### C. Rollover

Another feature common to all three Individual Retirement Savings Plans is the "rollover" system. Under this provision, a participant may in certain circumstances "roll over" a lump sum distribution from one plan into another and defer the taxes that would otherwise be owed at the time of distribution.<sup>31</sup> This system lends greater flexibility to an individual's retirement plan by enabling the taxpayer to adapt the plan to his changing circumstances, *e.g.* movement from one location to another, or displeasure with the current plan or with the way one's money is being invested.

Under this system the individual taxpayer has three options.<sup>32</sup> The first is a tax-free transfer from a qualified plan to an individual retirement account, annuity, or bond. There are limitations imposed upon such transfers, however. The individual's balance in the qualified plan must be paid to him within one taxable year as a lump sum distribution and must be payable by reason of his termination of service.<sup>33</sup> In addition, the amount to be transferred to the new account is the value of the employee's qualified plan less his contributions. An employee can only roll over that portion of a qualified plan which the employer contributed.<sup>34</sup> Finally, if non-cash property is re-

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<sup>28</sup> See also PUBLICATION No. 590, *supra* note 7, at 4. Thus the tax break accorded to qualified pension plans is still greater than that accorded to Individual Retirement Savings Programs. Not only do lump sum distributions from qualified pension plans qualify for 10-year income averaging, they may also qualify for capital gains treatment.

<sup>29</sup> *Id.*

<sup>30</sup> IRC § 37(c).

<sup>31</sup> Rollovers involving individual retirement savings plans are authorized by IRC § 408(d)(3) for individual retirement accounts and annuities. See also Proposed Treas. Reg. § 1.408(b)(2), 40 Fed. Reg. 7663 (1975). Rollovers are authorized for bonds in IRC § 409(b)(3)(c). See also Proposed Treas. Reg. § 1.409-1(c), 40 Fed. Reg. 7671 (1975).

<sup>32</sup> IRC § 408(d)(3). See also Fischer & Berger, *supra* note 18, at 217-18.

<sup>33</sup> Colby, *Scope of Rollover Provisions in New Law for Lump Sum Distributions*, 43 J. TAXATION 7 (1975).

<sup>34</sup> IRC § 408(d)(1). See also PUBLICATION No. 590, *supra* note 7; Fischer & Berger,



ceived from the old qualified plan, it must be transferred to the IRSP in the same form in which it was received. The fair market value of the transferred asset at the time of transfer is used to determine its value.<sup>35</sup> The second option is a tax-free transfer from an individual retirement account, annuity, or bond to another account, annuity, or bond.<sup>36</sup> The third is a tax-free transfer from one qualified plan to another qualified plan by use of an IRA. This conduit account, however, can contain only the assets transferred from the previous qualified plan.<sup>37</sup>

The availability of these options is further limited by the IRC.<sup>38</sup> Identical assets must be deposited in the new account within 60 days of distribution from the original account. For example, if an individual receives \$8,000 in cash and 500 shares of stock, everything must be deposited into the new plan or account.<sup>39</sup> In addition, a rollover is permitted only once every 3 years, and only one deposit is allowed to a rollover; no further money can come into the IRA account except through interest on the rollover.<sup>40</sup> The limitation on deductions of the lesser of 15 percent or \$1,500 does not apply to rollovers, however.<sup>41</sup> Thus, in a given year, a taxpayer can avoid taxes on a lump sum distribution by making a rollover contribution to one IRSP and *also* making a deductible contribution to another plan.<sup>42</sup>

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*supra* note 18, at 218; Roth, *The Individual Retirement Account: Clarification of Proposed Regulations*, 114 TRUSTS & ESTATES 380, 435 (1975).

One option is *not* available to the taxpayer: an IRSP which contains assets originally in a Keogh Plan may not be rolled over into a qualified employer's pension plan. PUBLICATION No. 590, *supra* note 7, at 4.

<sup>35</sup> AMERICAN BANKING ASS'N., *supra* note 3, at 12; telephone interview with David Crume, IRS Pension Trust Division, in Louisville, Kentucky June 20, 1975.

<sup>36</sup> IRC § 408(d)(3)(A)(i); IRC § 409(b)(3)(C).

<sup>37</sup> IRC § 408(d)(3)(A)(ii); IRC § 409(b)(3)(C).

<sup>38</sup> IRC § 408(d)(3).

<sup>39</sup> AMERICAN BANKING ASS'N., *supra* note 3, at 12. Another commentator asserts that the identical assets rule might apply only to rollovers from qualified plans. He argues that an individual who is merely rolling over assets from one type of individual retirement plan to another is not required to withdraw the *entire* amount in the first plan. Thus, he could diversify the investment by drawing out and reinvesting only a portion of the account.

The 60 day period during which a plan participant may roll over his distribution runs from the day he has cash or other assets in hand. Colby, *supra* note 33, at 7.

<sup>40</sup> IRC § 408(d)(3).

<sup>41</sup> Roth, *supra* note 34, at 435.

<sup>42</sup> An individual who utilizes the rollover system and wishes to make tax deductible contributions as well can do so, but only through the simultaneous use of several

These options actually coalesce into two basic types of rollovers: a rollover which is only a means for changing the type of IRSP and one used as a tax deferment on a lump sum distribution from a qualified plan.<sup>43</sup>

As might be expected, this section of the statute involves severe interpretation problems. For example, the requirement that the balance in the employee's account of a qualified plan must be paid to him in a lump sum because of his termination of service is not as simple as it appears. If the employee has reached the minimum retirement age as established by statute,<sup>44</sup> it seems clear that he received his distribution by reason of termination of service. If, however, the employee has not reached this age, one must ask why the distribution became payable. Termination of the plan, for example, might cause a distribution to fail to qualify as a lump sum<sup>45</sup> even though the employee's service is terminated prior to distribution. This would be true in cases where an employer goes out of business, terminating both plan and employee.<sup>46</sup>

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Individual Retirement Savings Plans—one for each rollover contribution and one for tax deductible contributions. See Fischer & Berger, *supra* note 18, at 218.

<sup>43</sup> Colby, *supra* note 33, at 7.

<sup>44</sup> The minimum distribution age is 59½. IRC § 408(f)(i) (individual retirement accounts and annuities); IRC § 409(c)(i) (individual retirement bonds).

<sup>45</sup> Colby, *supra* note 33, at 8.

<sup>46</sup> *Id.* at 10. Colby argues that rollovers from qualified plans should also be allowed upon plan termination. See also H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 344 (1975); H.R. 10612, 94th Cong., 2d Sess. § 1501.

Unfortunately, that portion of the House version of the Act containing revisions in the rollover contributions which would have resolved many of these ambiguities was not enacted. The House had proposed that asset distribution caused by plan termination or the complete discontinuance of contributions be treated as lump sum distributions just as distributions caused by termination of service; this would qualify them for rollover treatment. This change would have been retroactive "so as to achieve as nearly as practical the results that would have been achieved had the rule been enacted as part of ERISA." H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 344 (1975); H.R. 10612, 94th Cong., 1st Sess. Title XV, § 1501(a)(i)(A)(i)(ii), (b)(1)(A)(i)(ii) [hereinafter cited as 1975 Tax Reform Act]. In order to provide this retroactive treatment, the new rules would have been applicable to distributions made to employees on or after July 4, 1974 (60 days before the date of the enactment of ERISA under which this tax-free rollover treatment became available). H.R. Rep. No. 94-658, H.R. 10612, *supra* this note.

An employee who received a plan termination distribution of property, however, believing that he could not roll it over, may have sold or exchanged the distributed property. In such a case, the employee would be taxed on any gain from the sale or exchange and also would be precluded from rolling over the proceeds of the sale, by the "same property rule." See H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 345 (1975).

Another troublesome question is whether the distribution will qualify as a lump sum distribution. For example, the employee who has received part of his account balance and hopes to receive the rest in the same taxable year will not know until the end of the year whether the initial distribution is part of the lump sum. In deciding whether he should roll over this partial distribution, the employee is caught between the 60 day period in which he must act to qualify for the rollover, and the possibility that if he does act within the 60 day period, his rollover will fail anyway because he failed to receive the rest of the distribution within the taxable year.<sup>47</sup>

Other problems arise with receipt of the rollover contribution by the IRSP trustee. Where the beneficiary of an individual retirement account or annuity is seeking distribution from that plan but has not reached the minimum distribution age of 59½ and is not disabled, the trustee can make the requested distribution only if he obtains a signed statement from the beneficiary indicating that the distribution will be used as a rollover contribution.<sup>48</sup> Unfortunately there is no guidance as to what the trustee of a qualified plan maintained by a successor employer should require in connection with *accepting* a rollover contribution.<sup>49</sup> Moreover, if a subsequent audit should reveal that the rollover contribution did not meet the requirements of the act (e.g., distribution was made by reason of termination of the plan rather than by the employee's separation from serv-

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As pointed out earlier, if property is received from the old qualified plan, the same property must be transferred to the new plan. See Proposed Treas. Reg. 1.408-1(b)(ii)(B), 40 Fed. Reg. 7667 (1975).

This situation would have frustrated the retroactive application of the new liberalized rollover rules. For this reason, the House provided that where property distributed by reason of plan termination or contribution discontinuance was sold or exchanged during the period before enactment of the bill, the proceeds of the sale may be rolled over. 1975 Tax Reform Act § 1501(c)(2). In addition, the House bill provided for the nonrecognition of gain or loss on sale or exchange to the extent these proceeds are rolled over. 1975 Tax Reform Act § 1501(c)(3).

<sup>47</sup> Colby, *supra* note 33. This problem may be partially eliminated by the extension of time for IRSP contributions given by the 1976 Tax Reform Act. For taxable years beginning after 1976, such contributions may be made up to 45 days after the end of the taxable year. See IRC §§ 219(a)(3) and 220(c)(4).

<sup>48</sup> *Id.* at 8. See also Roth, *supra* note 33, at 435; Proposed Treas. Reg. § 1.408-1(b)(iv), 40 Fed. Reg. 7667 (1975). Apparently the requirement of a signed statement applies only to individual retirement accounts and annuities as the regulations on bonds are silent on this point.

<sup>49</sup> Colby, *supra* note 33.

ice), it is not clear whether disqualification of the rollover will also result in disqualification of the successor employer's plan.<sup>50</sup>

Another question is whether the trustee of the successor qualified plan should be allowed to accept stock in the former employer's company as part of the rollover contribution. If this is not permitted, the employee is hampered because the statute requires that the identical assets received in the distribution be rolled over.<sup>51</sup> If the trustee is allowed to accept the stock, however, the successor plan might be forced to hold stock of questionable value.<sup>52</sup>

Finally, rollovers might in reality be of rather limited application. One commentator asserts that because of the undesirable tax consequences which might ensue from their use, rollovers should be used only where tax deferral is of paramount importance.<sup>53</sup> For example, when amounts are rolled over from a corporate qualified plan into an IRSP, the employee loses the capital gain treatment which would have been given a lump sum distribution from the qualified plan. In its place he receives ordinary income treatment upon subsequent distribution from the IRSP.<sup>54</sup> This amounts to a substantial

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<sup>50</sup> *Id.* One could argue, however, that this would not disqualify the employer's entire plan: in an analogous situation, an employee's premature withdrawal from a group Individual Retirement Account disqualifies only his portion of the plan, not the entire plan. It would be inconsistent to treat a rollover situation differently. See Proposed Treas. Reg. § 1.408-2(d)(i), 40 Fed. Reg. 7669 (1975). Although the regulations are not explicit, the same result would be expected from disqualification of an annuity; each contract could be treated as a separate unit. See Proposed Treas. Reg. § 1.408-3(c), 40 Fed. Reg. 4670 (1975). The bond regulations are silent on the subject of group bond purchase plans, but it should be just as easy to treat each bond as a separate unit, thus avoiding disqualification of the entire plan.

<sup>51</sup> Colby, *supra* note 33, at 9.

<sup>52</sup> *Id.* The same problem arises in the case of a rollover to an IRSP administered by a bank. The American Banking Association warns that "a national bank without trust powers cannot accept a rollover if it contains noncash assets such as stock. State-chartered banks will have to check their state laws and/or regulatory authorities on this point." AMERICAN BANKING ASS'N, *supra* note 3, at 13. The way to avoid the problem of authority to accept stock or desirability of doing so is for the recipient bank or trustee to request the trustee of the qualified plan to sell *all* the noncash assets before distribution is made. See AMERICAN BANKING ASS'N, *supra* note 3, at 13.

<sup>53</sup> Fischer & Berger, *supra* note 18, at 218.

<sup>54</sup> *Id.* A Lump sum distribution from a qualified plan can qualify for long term capital gain treatment if it: (1) Is made within one taxable year, (2) becomes payable only upon occurrence of certain enumerated events, (3) comes from a qualified plan,

increase in tax liability because the lost capital gain rates are roughly half those of ordinary income tax.

Thus, workers who never before were covered by any sort of plan can now establish IRSP's and fund them with tax deductible contributions. Moreover, the principal and the interest accrued in the operation of these plans are tax-free until the time of distribution. The IRSP provisions, however, do not yet place workers who are not covered by or eligible for qualified pension plans on a parity with those workers who are. Because lump sum distributions from qualified plans qualify for capital gain treatment and 10 year income averaging while lump sum distributions from IRSP's do not, qualified plan participants still receive more favorable tax treatment.

#### D. *Restrictions on the Use of Individual Retirement Savings Plans*

To get even these relatively modest tax advantages, the taxpayer using IRSP's must fight his way through a thicket of requirements, restrictions, and limitations avoiding many traps along the way.<sup>55</sup> Any violation results at minimum in an increased tax liability and might result in disqualification of the total IRSP.

##### 1. *Nonforfeitability*

An individual's interest in an IRSP must be "nonforfeitable."<sup>56</sup> Unfortunately, neither the statute nor the proposed reg-

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(4) is attributed to a pre-1974 period. Chadwick & Porter, *Federal Regulation of Retirement Plans: The Quest for Parity*, 28 VAND. L. REV. 641, 681 (1975).

In addition, it is conceivable that assets rolled over into an IRSP from a qualified corporate plan will later be rolled back into another corporate plan. If this happens it is not clear whether the assets will regain their preferred capital gain treatment and special 10-year averaging potential when distributed from the second corporate plan. Fischer & Berger, *supra* note 18, at 218.

<sup>55</sup> During its consideration of the 1974 Pension Reform Bill, the House Ways and Means Committee changed its mind twice, first tentatively agreeing to the IRSP principle, then rejecting it, and finally reinstating its original decision. The fact that this committee was not totally sold on the IRA might account for the booby traps set for the unwary taxpayer failing to follow all the rules. Hall, *supra* note 3. Although Hall refers only to IRA's, most of the traps apply to individual retirement annuities and bonds as well.

<sup>56</sup> IRC § 408(a)(4) (individual retirement accounts); IRC § 408(b)(5) (annuities). The regulations governing these two plans do not mention forfeitability.

ulations define this term. It probably means, however, that in the case of an employer sponsored IRSP, the plan must be vested and not subject to employer-imposed requirements that the employee work a certain number of years to become eligible for the plan.<sup>57</sup> In addition, it must mean that the plan can not be made revocable by the employer.<sup>58</sup>

## 2. Excess Contributions

The statute imposes an excise tax of 6 percent on that portion of an annual contribution which exceeds the \$1500 or 15 percent of compensation limit.<sup>59</sup> This excise tax is not de-

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Conceivably, the Federal Reserve penalty imposed on premature withdrawal of IRA time deposits could be held to be a forfeiture, thus violating the nonforfeitable provision of the law. The American Banking Association, however, feels that this is a remote possibility. See AMERICAN BANKING ASS'N, *supra* note 3 at 10. It is not clear whether the nonforfeitable requirement applies to bonds as both the statute and the regulations are silent on this point.

<sup>57</sup> Interview with Kennedy Clark, trust officer, Louisville Trust Company, June 20, 1975. An employer might find the option of establishing IRA's for his employees attractive, especially if he does not feel he can afford a qualified plan, or if he is an "owner-employee" within the meaning of the Keogh Plan requirements and cannot provide retirement benefits for all of his full-time employees with 3 or more years of service as required by the Keogh Plan Statute. The larger deductions available under the Keogh Plan, the lesser of 15 percent of compensation, \$3,500, or a flat minimum deduction of \$750 must be weighed against the economic burden of providing such benefits. IRC § 404(e)(1)(4). See also CCH Explanation, 3 CCH 1976 STAND. FED. TAX REP. ¶ 2613.001, which points out that a nonowner employee (e.g., a partner who owns 10 percent or less of a business), however, will probably prefer a Keogh plan since he gets the Keogh Plan's larger deductions and can make as many voluntary nondeductible contributions as he desires without being forced to provide similar benefits for his employees. Also, a lump sum distribution from such a plan, unlike that from an IRSP, may be entitled to capital gains treatment and is taxed only to the extent that it exceeds the self-employed persons voluntary nondeductible contributions to the plan.

Another advantage to the employer choosing an IRSP is that the amounts he contributes will be included in compensation of the employee and be deductible by him as a business expense. CCH Explanation, 3 CCH 1976 STAND. FED. TAX REP. ¶ 2663M.02(4). The amounts included in the employee's compensation will be subject to Social Security, FICA and unemployment taxes. But income tax withholding will not be required if the employer reasonably expects that the employee can deduct such amounts under IRC § 219. See also Lordquist, *The Pension Remodeling Act of 1974*, 52 TAXES 873 (1974). For a discussion of the changes made by the Employee Retirement Income Security Act of 1974 in the already existing Keogh (H.R. 10) option, see Feldgarden, *Self-Employed Retirement Plans in Symposium, New Developments in Tax Administration and Pension Plans*, 27 NAT'L TAX J. 453 (1974); Sanchez & Cain, *The Pension Reform Act of 1974: Effective Dates* 5 TAX ADVISER 679 (1974).

<sup>58</sup> Clark interview, *supra* note 57.

<sup>59</sup> IRC § 4973. This excise tax is also imposed on contributions exceeding the limits

ductible, but taxpayers can avoid it by having the excess amount along with its earnings returned to him. This refund, however, must be made *on or before* the date on which the individual's tax return is due. This includes extensions but does not include time for filing an amended return.<sup>60</sup> For example, if an individual files his return in February and receives his excess contributions in March, he still avoids the excise tax because he received the excess before the due date (April 15 for

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imposed on IRSP's for married homemakers by the new IRC § 220(b). The rationale for the 6 percent excise tax on Keogh Plans also applies here: The 6 percent tax was thought to be equivalent to the exemption from income tax accorded to earnings on the excess contribution. See Feldgarden, *supra* note 57, at 455.

<sup>60</sup> CCH Explanation, 7 CCH 1976 STAND. FED. TAX REP. ¶ 4999EE.01. One way to avoid the problem of returning excess contributions to avoid the excise tax would be to follow the lead of Keogh Plan regulations limiting deductible contributions but allowing voluntary nondeductible contributions. CCH Explanation, 3 CCH 1976 STAND. FED. TAX REP. ¶2613.19 (owner-employer contributory retirement plans); ¶2613.02 (nonowner employees). Thus the IRS would simply disallow any excess deductions and impose the excise tax only to the extent the excess exceeds the limits decided upon for voluntary, nondeductible contributions. To make the voluntary nondeductible contribution rule work, however, any IRSP regulations authorizing them would have to take care not to incorporate any Keogh Plan provisions which would impose a hardship on individual workers who do not have any employers, *e.g.*, the provision which makes all voluntary contributions excess contributions when they are given by an individual with no employees other than owner-employees.

Evidently Congress agreed that there were some ambiguities in the excess contribution rule since it amended the two Code sections dealing with the return of excess contributions. For taxable years beginning after 1976, the net income attributable to the excess contribution will be deemed to have been earned income receivable for the taxable year in which such excess contribution was made. CCH Explanation, CCH 1976 STAND. FED. TAX REP., Tax Reform Act of 1976 ¶509, *discussing* IRC § 408(d)(4) *as amended*. In addition, to be returnable the excess contribution must have been solely the result of contributions to a qualified or governmental retirement plan by the individual's employer made after the taxpayer established an IRSP, or contributions exceeding the 15 percent of compensation limitation imported by IRC §§ 219 or 220. If the excess contribution was more than the maximum allowable deduction of \$1,500 or \$1,750, the 6 percent penalty tax will be imposed whether the contribution was returned or not.

The maximum distribution allowable to avoid the 6 percent tax is the amount by which \$1,500 exceeds the allowable deduction under IRC § 219 or the amount by which \$1,750 exceeds the allowable deduction under IRC § 220. *Id.* This provision does not make sense. If the taxpayer contributed the maximum amount when he was not entitled to, the excess contribution would be the difference between those maximum figures and the 15 percent of compensation figure or twice the amount contributed to a nonworking spouse's IRSP figure. If the taxpayer contributed an amount in excess of the latter figures but not equaling the maximum figures above, it is not clear why the excess contribution would not simply be the difference between the amount actually contributed and the figure the taxpayer is entitled to deduct.

calendar year individuals). In addition to the excess being taxed in the year of contribution, the 6 percent tax is also levied for *every year* that the excess contribution remains in the IRSP. Although the taxpayer may be forced to pay the excise tax in the year of contribution because the excess was not properly returned to him, additional tax can be avoided in subsequent years. In a later year for which the individual is eligible to make an IRSP contribution, he may apply the excess amount already taken toward his contribution for that year. As long as the prior excess and the amount actually deposited do not exceed the maximum deductible contribution for that year there is no new excess and whatever portion of the prior excess is applied toward the current year's contribution is removed from excise tax liability.<sup>61</sup> The following example explains graphically how this provision works:<sup>62</sup>

#### Year 1975

Salary of taxpayer .....	\$9,000
Contribution .....	1,500
Maximum contribution allowed .....	1,350
	(15% of compensation)
Excess contribution .....	150
6% excise tax on 150 .....	9

Thus, in 1975 the taxpayer made an excess contribution and paid \$9 excise tax. In the year 1976, the taxpayer has two options:

#### Year 1976

Salary of above taxpayer .....	\$10,000
Maximum contribution allowable .....	1,500

If the taxpayer makes the maximum contribution in 1976, the \$150 excess from 1975 remains in his account and results in an additional \$9 excise tax for 1976. This can be avoided, however, by contributing only \$1,350 (\$1,500-\$150) in 1976.

If the taxpayer has an IRSP and later, during the same taxable year, elects to be covered by a qualified plan, all his IRSP contributions for that year will be deemed to be excess contributions. The taxpayer, however, can avoid this excise by

<sup>61</sup> CCH Explanation, 7 CCH 1976 STAND. FED. TAX REP. ¶4999EE.01.

<sup>62</sup> *Id.*



withdrawing his IRSP contribution for that year and any earnings attributed to those contributions. Again, this withdrawal must be made on or before the date his tax return is due.<sup>63</sup>

One commentator is critical of the 6 percent excise tax because it renders uneven justice:

[C]onceivably it will be advantageous for high-bracket taxpayers to make excess contributions, especially when the rate of return is high, a decrease in the applicable marginal tax rate is foreseeable, and a substantial deferral period is involved. On the other hand, a 6 percent tax may be excessive in the case of a low or middle-bracket taxpayer . . . .<sup>64</sup>

In addition, the possibility of a taxpayer making a deliberate excess contribution on the chance that he may not be caught is a very real one. To make matters worse, if he is caught, he is assessed the same penalty tax that a taxpayer making an innocent mistake is assessed.<sup>65</sup> Perhaps this is the real injustice in the excise tax system: intent is irrelevant. This injustice could be eliminated by imposing a stiffer excise tax on an intentional excess contribution, by disqualifying his entire IRSP and making all the assets includible in his gross income, not just the excess and its interest, or by forbidding him from participating in any IRSP for a specified number of years.<sup>66</sup> To aid in determining the taxpayer's intent, a presumption could be

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<sup>63</sup> *Id.*; Fischer & Berger, *supra* note 18, at 217. Funds contributed to the IRSP in years prior to the year in which the taxpayer elects coverage in the qualified plan can remain in the IRSP. *Id.* at 216. If the employee is also given prior service credits in the qualified plan for those same years, the double tax break discussed earlier occurs. *Id.*

<sup>64</sup> Feldgarden, *supra* note 57, at 455-56.

<sup>65</sup> *Id.*

<sup>66</sup> The regulations governing Keogh Plans make a distinction between inadvertent and intentional excess contributions and impose a stiffer penalty on the latter. If an inadvertent excess contribution is made, 3 CCH 1976 STAND. FED. TAX REP. ¶2612H, the amount of the excess contributions must be returned to the owner-employee (Keogh Plans distinguish between owner-employees and non-owner employees), on whose behalf it was made together with any income earned. The income so returned will be taxable to the self-employed person for whom the contribution was made. If an excess contribution is not repaid within six months after the receipt of notification, the plan will be held to be *temporarily disqualified* until the excess is returned. If an excess contribution is willfully made, however, the entire interest of the individual on whose behalf it was made in all plans in which he participates as an owner-employee, including the corpus allocated to his account, must be distributed to him. He is further disqualified from participating in any retirement plans as an owner-employee for a 5 year period. See Proposed Treas. Reg. § 1.401(e)-4(c)(ii)(1), 40 Fed. Reg. 17584 (1975).

included in the statute. For example, if the excess contributor's tax bracket changes as a result of the excess contribution, the excess contribution is presumed intentional.

### 3. *Premature Distribution*

To ensure that monies in IRSP's remain until the owners reach minimum retirement age, Congress has imposed a 10 percent penalty tax on premature distribution. Once an individual establishes an IRSP, the money he deposits *cannot* be withdrawn without penalty until he attains age 59½.<sup>67</sup> This provision, however, does not apply when the distribution is attributable to the death or disability of the participant.<sup>68</sup> Nor does this provision apply when the distribution is received as a rollover, or as a return of an excess contribution when the return is made before any excise tax is paid. If an individual receives funds from his IRSP under any other circumstances,

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<sup>67</sup> IRC § 408(f).

<sup>68</sup> IRC § 408(f)(3). Disability is defined in IRC § 72(m)(7):

An individual shall be considered to be disabled if he is unable to engage in any substantial activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the secretary or his delegate may require.

In addition, Fiscal Services, Treas. Reg., 31 C.F.R. § 346.8(b)(2)(i-ix) (1976) dealing with retirement bonds, offers some useful examples of impairments which would ordinarily prevent substantial gainful activity:

(i) Loss of use of two limbs.

(ii) Certain progressive diseases which have resulted in the physical loss or atrophy of a limb, such as diabetes, multiple sclerosis, or Buerger's disease.

(iii) Disease of the heart, lungs, or blood vessels which have resulted in major loss of heart or lung reserve as evidenced by X-ray, electrocardiogram, or other objective findings, so that despite medical treatment breathlessness, pain or fatigue is produced on slight exertion, such as walking several blocks, using public transportation or doing small chores.

(iv) Cancer which is inoperable and progressive.

(v) Damage to the brain or brain abnormality which has resulted in severe loss of judgment, intellect, orientation, or memory.

(vi) Mental diseases (e.g., psychosis or severe psychoneurosis) requiring continued institutionalization or constant supervision of the individual.

(vii) Loss or diminution of vision to the extent that the affected individual has a central visual acuity of no better than 20/200 in the better eye after best correction, or has a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

(viii) Permanent and total loss of speech.

(ix) Total deafness uncorrectible by a hearing aid.

the amount received must be included in gross income and the taxpayer must pay a 10 percent penalty on the amount received.<sup>69</sup>

### III. PROVISIONS UNIQUE TO INDIVIDUAL RETIREMENT ACCOUNTS

#### A. *Prohibited Transactions under IRC § 4975*

A taxpayer participating in an Individual Retirement Account is subject to the "prohibited transaction rules" of section 4975.<sup>70</sup> Violating these rules will result in the IRA's disqualification and loss of the tax deduction. Furthermore, as of the first day of the taxable year in which one of these prohibited transactions occurs, the account is treated as if all its assets have been distributed. The individual, therefore, is taxed on the fair market value of the account in the year in which the transaction occurs.<sup>71</sup> If an account is maintained by an employer or union, a prohibited transaction by one individual will result only in the disqualification of his separate account. Other members or employees will not be affected.<sup>72</sup> Borrowing from an account, selling property to or buying property from an account, receiving more than reasonable compensation for services performed for an account, or lending money or extending credit to an account are all examples of prohibited transactions.<sup>73</sup> If an IRA participant borrows money from his account, all the assets of the account are treated as distributed to him in an amount equal to the assets' fair market value on the first

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<sup>69</sup> The Code language indicates that the 10 percent tax is paid only on the amount actually withdrawn. See IRC § 408(f)(1). This conflicts with CCH's implication that since a constructive distribution results from disqualification of the account or annuity, the entire balance in the account is to be subject to the 10 percent penalty tax even though only a portion has been withdrawn. CCH Explanation, 3 CCH 1976 STAND. FED. TAX REP. ¶ 2663 M.08.

<sup>70</sup> IRC § 4975(c)(3). It is not clear whether a participant in an individual retirement annuity or bond is subject to the prohibited transactions rules in this section. PUBLICATION No. 590, *supra* note 7 at 5 asserts that participants in individual retirement annuities are also subject to these rules. IRC § 4975(c)(3), however, refers only to individual retirement accounts. Moreover, IRC § 408(e)(2)(A)(i), (ii), which applies § 4975 rules to IRSP sections, only refers to individual retirement accounts. Finally, Treas. Reg. § 346.6, 31 C.F.R. 432 (1976) which sets forth prohibited transactions for bonds, does not mention IRC § 4975 at all.

<sup>71</sup> IRC § 408(e)(2)(B).

<sup>72</sup> Proposed Treas. Reg. § 1.408-2(d)(2), 40 Fed. Reg. 7669 (1975). See also Hall, *supra* note 3, at 464.

<sup>73</sup> IRC § 4975(c)(1).

day of the taxable year in which the money was borrowed.<sup>74</sup> If, however, such an individual only pledges his IRA as security, only that portion of the account pledged is treated as distributed.<sup>75</sup> Moreover, if an individual borrows or pledges before attaining the age of 59½, the 10 percent penalty tax is also imposed on that portion treated as distributed.<sup>76</sup>

The IRA participant is not the only person subject to section 4975's prohibitions.<sup>77</sup> Any "disqualified person"<sup>78</sup> other than the individual IRA owner-beneficiary<sup>79</sup> or a fiduciary acting only as such<sup>80</sup> who engages in prohibited transactions will be assessed an excise tax on each prohibited transaction "equal to 5 percent of the amount involved with respect to the prohibited transaction for each year (or part thereof) in the taxable period."<sup>81</sup> If this tax is imposed and the prohibited transaction is not corrected after notice from the IRS, a tax equal to 100

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<sup>74</sup> IRC § 408(e)(2)(B).

<sup>75</sup> IRC § 408(e)(4). See also Fischer & Berger, *supra* note 18, at 219.

<sup>76</sup> CCH Explanation, 3 CCH 1976 STAND. FED. TAX REP. ¶2663 M.07.

<sup>77</sup> IRC § 4975(e)(2). As pointed out in note 70 *supra*, this section may not apply to all three IRSP options. A procedure has been established by which disqualified persons can obtain exemption from the prohibited transactions rule. Such an exemption, however, cannot be granted unless the secretary or his delegate consults and coordinates his action with the Secretary of Labor, finds that an exemption is administratively feasible, and that an exemption is in the interests of the plan and its participants and beneficiaries and is protective of their rights. See IRC § 4975(e)(2).

<sup>78</sup> IRC § 4975(e)(2) defines a "disqualified person" as one who is

- A) a fiduciary;
- B) a person providing services to the plan;
- C) an employer any of whose employees are covered by the plan;
- D) an employee organization any of whose members are covered by the plan;
- E) an owner, direct or indirect, of 50 percent or more of—
  - i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation,
  - ii) the capital interest or the profits interest of a partnership, or
  - iii) the beneficial interest of a trust or unincorporated enterprise, which is an employer or an employee organization described in subparagraph (C) or (D);
- F) a member of the family . . . of any individual described [above]. . . .

<sup>79</sup> The individual engaging in forbidden transactions with his own individual retirement account is not subject to this excise tax. IRC § 4975(c)(3). See also Fischer & Berger, *supra* note 18.

<sup>80</sup> IRC § 4975(a). See also Weiss & Voboril, *Fiduciary Standards and Investment Responsibility under the New Pension Reform Law*, 113 TRUST & ESTATES 800 (1974).

<sup>81</sup> IRC § 4975(a). This tax is imposed for the taxable year of the transaction and for each subsequent year during which the prohibited transaction is not corrected. CCH Explanation, 7 CCH 1976 STAND. FED. TAX REP. ¶ 4999 K.01.

percent of the amount involved will be levied on the disqualified person unless this person is a fiduciary acting only as such or is an individual IRA owner-beneficiary.<sup>82</sup>

These taxes are *not* deductible.<sup>83</sup> Moreover, these excise taxes are imposed on a disqualified person even if the violation is inadvertent.<sup>84</sup> In addition, paying the tax does not relieve the disqualified party of his obligation to correct the transaction or his duty to the plan.<sup>85</sup> If more than one person is liable for the excise tax on a prohibited transaction, the liability is joint and several.<sup>86</sup>

### B. *Purchase of Life Insurance with IRA Funds*

The reason for this prohibition<sup>87</sup> is obvious: Congress intended IRA funds to be used primarily for retirement. IRA funds can be used to purchase auxiliary life insurance protection, but only through an endowment policy which provides a substantial savings element. This power is also subject to limitation. Assets used to purchase an endowment contract which are *not* attributable to the purchase of life insurance are treated as rollover contributions,<sup>88</sup> while assets attributable to the purchase of life insurance are treated as *distributed* to the individual. While this is true, however, provisions regarding additional tax on assets distributed before age 59½ and their inclusion in gross income do not apply. If different or more

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<sup>82</sup> IRC § 4975(b).

<sup>83</sup> CCH Explanation, 7 CCH 1976 STAND. FED. TAX REP. ¶ 4999 K.01.

<sup>84</sup> Weiss & Voboril, *supra* note 80.

<sup>85</sup> CCH Explanation, 7 CCH 1976 STAND. FED. TAX REP. ¶ 4999 K.01.

<sup>86</sup> *Id.* Certain transactions, however, are not prohibited. For example, under IRC § 4975(d)(1)(A-E), a "disqualified person" who is a participant in or beneficiary of a group plan can borrow money from the plan if the loan:

A) is available to all such participants or beneficiaries on a reasonably equivalent basis,

B) is not made available to highly compensated employees, officers, or shareholders in an amount greater than the amount made available to other employees,

C) is made in accordance with specific provisions regarding such loans set forth in the plan,

D) bears a reasonable rate of interest, and

E) is adequately secured . . . .

See IRC § 4975(d)(1-13) for the transactions which are not forbidden by this section.

<sup>87</sup> IRC § 408(a)(3).

<sup>88</sup> Proposed Treas. Reg. § 1.408-1(6), 40 Fed. Reg. 7667 (1975).

complex forms of life insurance are desired, they must be obtained with non-IRA funds.<sup>89</sup>

The proposed regulations also permit investment of IRA funds in annuity contracts providing death benefits not based on mortality assumptions.<sup>90</sup> This is true if payment begins at death, disability or retirement between the ages of 59½ and 70½.<sup>91</sup>

### C. Comingling of IRA Assets with Other Property

The assets in an IRA cannot be comingled with other property *except* when this property is in the form of a common trust or investment fund.<sup>92</sup> This means that funds of one IRA may be combined for investment with funds from other IRA's and with funds from qualified pension or profit sharing plans. This combination would enable the individual to enjoy a higher rate of return than would otherwise be available to him.<sup>93</sup>

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<sup>89</sup> Hall, *supra* note 3, at 463. Despite the prohibition on life insurance, there are a number of ways in which IRA funds can be invested. They can be placed in trust with a bank or trust company. (Rollover IRA's, however, might be too small to make that option feasible). They can also be placed in one or more custodial accounts with a bank or other qualified custodian, or be invested in the type of annuity previously discussed. Finally they can be placed in mutual funds or other securities, or in special Treasury Bonds designed to meet IRA needs which will be issued. *Id.* See also Lerner & Dankner, *Highlights of the 1974 Pension Reform Legislation*, 5 TAX ADVISOR 646, 667 (1974).

<sup>90</sup> Proposed Treas. Reg. § 1.408-2(b)(3), 40 Fed. Reg. 7668 (1975).

<sup>91</sup> Hall, *supra* note 5.

<sup>92</sup> IRC § 408(e)(6). See also Proposed Treas. Reg. § 1.408-2(5)(ii), 40 Fed. Reg. 7668 (1975). This regulation defines a "common investment fund" as a group trust created for the "purpose of providing a satisfactory diversification of investments or a reduction of administrative expenses for individual participating trusts." This group trust must meet the requirements of IRC § 408(c), covering accounts established by employers and certain associations of employees.

An "employee association" is any organization composed of two or more employees *including* but not limited to an employee association described in IRC § 501(c)(4). Proposed Treas. Reg. § 1.408-2(c)(ii), 40 Fed. Reg. 7669 (1975).

<sup>93</sup> Fischer & Berger, *supra* note 18, at 215. These authors also observe that the ability to commingle should make IRA's more attractive to financial institutions which might not otherwise be interested in handling the small IRA amounts. See also Rev. Rul. 75-530, 1975-2 CUM. BULL. 146 which states:

[t]he assets of qualified individual retirement accounts may be pooled with the assets of qualified section 401(a) trusts, without adversely affecting the tax-qualification of either the individual retirement accounts or the section 401(a) trusts.

### D. *Payout Provisions*

If the taxpayer manages to emerge from the jungle of restrictions unscathed and reach a point at which he can begin withdrawing funds from his IRA without violating the premature distribution rules, he must then determine the most advantageous payout method without violating the minimum distribution requirements.<sup>94</sup>

An individual can withdraw funds from an IRA at any time and in any amount after he reaches 59½.<sup>95</sup> This ability to withdraw, however, was not always as easy as it sounds. IRA participants were originally trapped between the provision authorizing withdrawal of funds at age 59½ or disability and Federal Reserve regulations imposing penalties for premature withdrawal on time deposits.<sup>96</sup> This situation would arise when an individual sets up an IRA via a certificate of deposit at the age of 59. Although he could begin withdrawing from his IRA at age 59½ and incur no penalty under ERISA, under the then-existing Federal Reserve rules he could not withdraw any money within 6 months without incurring substantial interest penalties. A similar problem arose when an individual began withdrawing from his IRA time deposit before the expiration of the then-typical 1 year waiting period and before he reached

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<sup>94</sup> See Proposed Treas. Reg. § 54.4974-1(b), 40 Fed. Reg. 7673 (1975); Proposed Treas. Reg. § 1.408-2(b)(6), 40 Fed. Reg. 7668 (1975).

<sup>95</sup> Participants in annuity and bond plans can also withdraw money depending on the contract and redemption schedule. Individual Retirement bonds are governed by 31 C.F.R. § 346.8(c) (1976) which establishes several ways of verifying that the owner of an individual retirement bond has attained the age of 59½. Such methods are necessary when the Secretary of the Treasury is not satisfied that the date of birth shown on the face of the bond is sufficient proof of age and a certified copy of the owner's birth certificate is not available. This list would also be useful in resolving IRS and taxpayer disagreements over imposition of the premature distribution tax on distributions from IRA's and IRAN's. The following can be used as proof of age in such disputes:

- (i) Church records of birth or baptism
- (ii) Hospital birth record or certificate
- (iii) Physicians or midwife's birth record
- (iv) Certification of Bible or other family record
- (v) Military, naturalization or immigration records
- (vi) Other evidence of probative value. *Id.*

<sup>96</sup> These regulations would certainly have applied to most IRA's. The obvious way to invest such a potentially long-range deposit would be to purchase a high yielding time deposit.

the minimum required age of 59½. In this case, he incurred both IRA and Federal Reserve penalties.

Because of this injustice, the American Banking Association Executive Director for Government Relations, Gerald M. Lowrie, urged the chairman of the Federal Reserve Board to create a new time deposit account which would be excluded from the Federal Reserve penalties for premature withdrawal.<sup>97</sup> In lieu of imposing the same Federal Reserve penalties attaching to other time deposits, Lowrie suggested the incorporation of IRS penalties for infractions of IRSP rules into the Federal Reserve regulations, including the 6 and 10 percent penalty taxes. This action would eliminate the injustice of the first situation and the exposure to double penalties of the second, but still achieve the Federal Reserve's desire to penalize early withdrawal on time deposits.<sup>98</sup> Lowrie reasoned that this would preclude the application of penalties in the event of early withdrawal due to death, disability, and rollovers;<sup>99</sup> these with-

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<sup>97</sup> Letter from Gerald M. Lowrie, Executive Director for Government Relations, American Banking Association to Arthur F. Burns, Chairman of the Federal Reserve Board, Mar. 18, 1975. AMERICAN BANKING ASS'N., *supra* note 3.

<sup>98</sup> *Id.* Lowrie's letter, however, was not solely motivated by concern for the hapless taxpayer. He was also concerned that under the then-existing interest rate ceilings established by Regulations Q and 329.4, individuals choosing to maintain IRA funds in bank savings and time deposits would be discriminated against because of rate differentials enjoyed by thrift institutions. This would put commercial banks at a competitive disadvantage.

<sup>99</sup> *Id.* See also Federal Deposit Insurance Corp. News Release (June 25, 1975) (hereinafter referred to as FDIC). In this release, the FDIC also expressed concern that such penalties would be imposed under the existing system, and that banks would be unduly burdened in their attempts to minimize the effect of such penalties upon rightful distribution from IRA's.

[i]nsured nonmember banks maintaining IRA deposits would have to arrange the maturities of those deposits so that they come due at sufficiently brief intervals. This could impose a substantial burden on individual participants and banks to keep track of maturing deposits and to plan schedules for distribution at retirement accordingly.

This release also expressed concern about placing commercial banks at an unfair competitive advantage, and expressed interest in the concept of a new type of deposit for IRA funds. The following characteristics were suggested:

- (a) The maximum allowable rate of interest would increase over time so that a bank would be permitted to pay higher rates of interest on IRA deposits that remain in the bank for correspondingly longer periods of time.
- (b) An IRA participant nearing retirement would be allowed to convert an existing long-term deposit to an "IRA Payout Certificate" that would permit the participant to receive periodic payouts at either a reduced interest penalty or no penalty at all in exchange for the participant's commitment to retain IRA funds on deposit for a specified period of time.



drawals are authorized by the Act.

In response to this pressure, the Federal Reserve Board and the Federal Deposit Insurance Corporation amended their respective interest-on-deposit regulations. These regulations now permit payment pursuant to an IRA agreement *prior* to the maturity of the IRA time deposit without interest penalty for early withdrawal whenever the individual meets IRS requirements for withdrawal without penalty.<sup>100</sup>

If an IRA participant desires, however, he can delay distribution until the end of the year in which he reaches age 70½,<sup>101</sup> but distribution may begin at this time. In addition, the distribution must be carried out ratably over the lifetime of the participant or the lives of the participant and spouse.<sup>102</sup> This distribution may be in one of the following forms:

(a) Lump sum. From a tax standpoint this is the least desirable form of distribution because the recipient must include the entire amount as *ordinary* income in the year of receipt. He could, however, minimize the effects of lump-sum taxation by using the 5 year income averaging technique available to all taxpayers.<sup>103</sup>

(b) Payments over an ascertainable period of time. Payments may be received over: (1) The life of the individual, (2) the joint lives and last survivor expectancy of the individual

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<sup>100</sup> Fed. Reserve Reg. Q., 12 C.F.R. § 217.4(d)(1976); FDIC Reg., 12 C.F.R. § 329.4(d)(1976). *See also* Letter from Willis G. Moreman, Executive Vice President, Kentucky Bankers Association to members of the Association, Dec. 23, 1975.

Moreover, banks may waive, for IRA's, the \$1,000 minimum requirement for time deposits with 4 to 6 year maturities. This allows a brand new IRA of less than \$1,000 to be invested in a high-yielding certificate of deposit paying 7¼ percent-7¾ percent interest. Fed. Reserve Reg. Q., 12 C.F.R. § 217.7(b)(2) n.2 (1976); FDIC Reg., 12 C.F.R. § 329.7(b)(4) n. 14b (1976).

<sup>101</sup> This is also available to the holder of an Individual Retirement Annuity. Apparently the holder of an Individual Retirement Bond is not given the option of taking ratable annuity-type payments in lieu of a lump sum distribution. Proposed Treas. Reg. § 1.409-1(b)(1), 40 Fed. Reg. 7671 (1975) states that *all* of the proceeds of the bond obtained upon redemption are includible in the gross income of the taxpayer entitled to such proceeds. The regulations governing bonds say nothing about ratable payments.

<sup>102</sup> IRC § 408(a)(6) (individual retirement accounts). *See also* IRC § 408(b)(3) (individual retirement annuities). The 70½ figure is also the cutoff point for making contributions to the IRSP: An individual who has reached age 70½ is no longer eligible to make tax-deductible contributions to an IRSP. IRC § 219(b)(3). It is unclear whether this means that he is prohibited from making any contribution at all or whether he can, as in a Keogh Plan, still make voluntary nondeductible contributions.

<sup>103</sup> PUBLICATION no. 590, *supra* note 7, at 4.

and his spouse, (3) a period not extending beyond the life expectancy of the individual, (4) a period not extending beyond the joint life and last survivor expectancy of the individual and his spouse.<sup>104</sup>

One of the periodic payments is more desirable because the individual pays tax only on the income received in that taxable year.<sup>105</sup> While the rules for periodic payments are intricate and ambiguous, a taxpayer is liable for additional penalty taxes if they are not followed. For example, to enforce the requirement that payouts after age 70½ be of a certain amount, the law imposes an excise tax of 50 percent on the difference between the amount required to be paid and the amount actually received.<sup>106</sup>

One possible way for a bank to get around this distribution problem is to accept the new account. If the depositor then decides he wants to elect one of the annuity pay-out options, the bank can suggest that the participant wait until retirement at which time he would withdraw his IRA funds and use them to buy an insurance company's annuity. This would leave it to the insurance company's actuaries to figure out the payout rules.<sup>107</sup> There are, however, major drawbacks to this decision

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<sup>104</sup> Proposed Treas. Reg. § 1.408-2(b)(6)(iii), 40 Fed. Reg. 7668-7669 (1975) (individual retirement accounts). See also Proposed Treas. Reg. § 1.408-3(b)(3), 40 Fed. Reg. 7670 (1975) (individual retirement annuities).

<sup>105</sup> The agreement for the individual retirement account, however, might establish a deadline for making this election which, if not met, will foist a lump sum payment on a taxpayer who does not want it. See INT. REV. SERV. FORM NO. 5305-A, INDIVIDUAL RETIREMENT CUSTODIAL ACCOUNT, IV(e)(1975). Apparently there are two sets of rules governing the annuity-type payout provisions: one set for payments occurring *before* age 70½ and the other set for payments occurring *after* age 70½. Moreover, there are inconsistencies between the payout provisions in the IRS form number 5305-A prototype IRA and custodial account agreement and the proposed regulations. Compare FORM NO. 53-3-A, *id.* with Proposed Treas. Reg. § 54.4974-1(c)(2), 40 Fed. Reg. 7673 (1975).

<sup>106</sup> Proposed Treas. Reg. § 54.4974-1(a), 40 Fed. Reg. 7673 (1975). For example, if it is determined that the amount to be paid out in the year the taxpayer attains age 70½ is \$855, determined by dividing \$10,340 (the account balance as of January 1, 1991) by 12.1 years (the life expectancy of the depositor), and the amount actually distributed from the account that year is only \$608, H has an excise tax liability of \$123.50 (50% of \$855-\$608). Proposed Treas. Reg. 54.4974-1(c)(3), 40 Fed. Reg. 7673 (1975), example 3. Thus, the tax can be substantial.

<sup>107</sup> Louisville Trust is taking this approach and not discussing payout provisions with the customer at the time the account is established. Interview with Kennedy Clark, Trust Officer, Louisville Trust Co., June 25, 1975. The problem with this ap-

to delay the purchase of an annuity until time of retirement. One such drawback is that the annuity factor, *i.e.* the amount of money payable to a life insurance company in order for the company to guarantee the customer a level income for the rest of his life, will increase with time. This is true, because insurance companies assume life expectancy will increase with time. If the individual purchases an Individual Retirement Annuity at an early date, he will be charged a lower annuity rate,<sup>108</sup> and thus will be paying less money now than he would later for the same coverage. Another drawback to choosing the IRA is that opting for the bank-administered IRA causes the participant to forego certain features which the insurance company can incorporate into its annuity plan. For example, at least one life insurance company offers a "Waiver of Premium" program which is not available to a bank's IRA depositor. If one of the participants in an individual retirement annuity should become disabled for 6 months or longer, the company will continue to make deposits on his behalf. This will enable the participant to enjoy the deposits at retirement age even though he could not make the contributions himself.<sup>109</sup> The final factor to consider is that if the individual waits until retirement age to withdraw his IRA funds and to purchase an annuity, he might lose the tax-free rollover option. If this occurs, the taxpayer will be taxed twice on the same funds, once when the lump sum distribution is received from his IRA and again when his annuity payments are received from the insurance company.<sup>110</sup>

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proach is what to do when the day of reckoning finally comes and the customer wants to make withdrawals. This day could conceivably come before the bank has figured out the payout provisions; for example the customer may become totally disabled, and thus eligible to make withdrawals, well before the minimum retirement age.

<sup>108</sup> Letter from Steven I. Durkee, representative of The Manufacturer's Life Insurance Company, to Carol M. Lambert, Sept. 3, 1975.

<sup>109</sup> *Id.*

<sup>110</sup> Interview with Steven I. Durkee, representative of Manufacturer's Life Insurance Company, Sept. 15, 1975. The statute and proposed regulations do not speak directly to this point, but Proposed Treas. Reg. § 1.408-2(b)(6)(iii), 40 Fed. Reg. 7668 (1975) and Proposed Treas. Reg. § 1.408-3(b)(3), 40 Fed. Reg. 7670 (1975) point out that the individual retirement account must at least commence distribution at age 70 ½. Thus it is difficult to see how a rollover contribution made after that cut-off age could be allowed. A rollover from an IRA into an individual retirement annuity, however, would probable be allowable between the ages of 59½ and 70½. CCH Explanation, 3 CCH 1976 STAND. FED. TAX REP. ¶2663 M.05 makes this implication by stating that in order to qualify for a tax-free rollover, a distribution from a qualified plan must

#### IV. PROVISIONS UNIQUE TO INDIVIDUAL RETIREMENT ANNUITIES

##### A. Requirements

An Individual Retirement Annuity (IRAN) is an annuity or endowment contract issued by an insurance company.<sup>111</sup> Given the aforementioned disadvantages inherent in delaying the purchase of a retirement annuity, the taxpayer should consider this option at the outset. As with the IRA, the entire interest in the annuity must be nonforfeitable. In addition, the annuity or endowment contract cannot be transferable by the owner, and its annual premium cannot exceed \$1,500; any refunded premium is applied toward payment of future premiums or used to purchase additional benefits before the close of the calendar year following the year of refund.<sup>112</sup> The contract must also provide that the annuity owner can neither use the annuity as security for a loan nor borrow money under it. If this provision is violated, the contract ceases to be an IRAN as of the first day of the tax year, and "an amount equal to the fair market value of the contract as of the first day of the taxable year of the owner in which such contract is disqualified is deemed to be distributed to the owner."<sup>113</sup> Moreover, the annuity must be for the exclusive benefit of the annuitant or his beneficiary. Payout provisions of IRAN's are similar to those already discussed for IRA's.<sup>114</sup>

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be made because of the employee's separation from service or after the employee has attained age 59½.

<sup>111</sup> For the general requirements of IRAN's see IRC § 408(b).

<sup>112</sup> Proposed Treas. Reg. § 1.408-3(b)(2), 40 Fed. Reg. 7670 (1975).

<sup>113</sup> Proposed Treas. Reg. § 1.408-3(c), 40 Fed. Reg. 7670 (1975). In contrast, the penalty under the IRA differs depending upon whether the taxpayer borrowed from the IRA or pledged it as security for a loan. Conference Rep. No. 93-1090, 93d Cong., 2d Sess. 339 (1974).

<sup>114</sup> If the annuity owner dies before his entire interest has been distributed, the same rules as discussed in the next section apply. See notes 118-120 and accompanying text *infra*.

In the case of the payment of a death benefit under an endowment contract upon the death of the individual in whose name the contract is purchased, the portion of such payment which is equal to the cash value immediately before the death of such individual is not excludable from gross income under section 101(a) and is treated as a distribution from an individual retirement annuity. The remaining portion, if any, constitutes current life insurance protection and is excludable from gross income under section 101(a).

Proposed Treas. Reg. § 408-3(e)(2), 40 Fed. Reg. 7670 (1975).

### B. *Determination of Nondeductible Portion*

That portion of the annuity or endowment premium allocable to life, health, or other types of insurance is not tax deductible.<sup>115</sup> To allocate the premium between the cost of insurance and savings for retirement, a "cost of insurance" formula is employed.<sup>116</sup> Under this formula the Commissioner determines the "net premium cost" per thousand dollars of insurance and applies this according to the age of the participant. The cash value of the endowment contract is subtracted from the total death benefit and this total is multiplied by the applicable "net premium cost." This results in the "cost of insurance" which is subtracted from the total yearly contribution. This difference is deductible.

For example: Mr. X purchases an endowment contract which provides annuity payments of \$50 per month, and minimum death benefits of \$15,000, at an annual premium of \$300.<sup>117</sup> The net premium cost as determined by the Commissioner is \$1.61 per thousand dollars of life insurance coverage. The cost of life insurance protection is \$24.15 [ $(\$15,000 - 0 \times .00161)$ ]. Thus, Mr. X's maximum deduction under section 219 would be \$275.85 ( $\$300 - \$24.15$ ). If the endowment contract had a cash value of \$1,000, the cost of life insurance protection would be \$22.54 [ $(\$15,000 - \$1,000) \times .00161$ ] and the deductible amount for that taxable year would be \$277.46 ( $\$300 - \$22.54$ ).

Because payments for the life insurance element are not tax deductible, the amount of the allowable deduction for an IRAN is likely to be much less than that allowed for an IRA or an Individual Retirement Bond. This portion, however, though nondeductible, will create a tax break if the endowment contract calls for a death benefit payment. When this payment is made, an amount equal to the cash value of the policy immediately before death is treated as a distribution from an individual retirement annuity and is therefore included in the dece-

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<sup>115</sup> Roth, *supra* note 34, at 381. An individual retirement annuity does not necessarily include a life insurance element. For example, Manufacturer's Life Insurance Company offers a plan with no life insurance, one with incidental life insurance, and a plan combining both. Letter from Steven I. Durkee, *supra* note 108.

<sup>116</sup> Roth, *supra* note 34.

<sup>117</sup> *Id.*

dent's gross income.<sup>118</sup> The remaining portion of the death benefit constitutes current life insurance protection and is totally excluded under section 101(a).<sup>119</sup> Finally, if a death benefit is paid under an endowment contract at a date or dates later than the death of the individual, section 101(d) excludes from taxation that portion of the benefit which is excludable from gross income under section 101(a).<sup>120</sup>

Not all endowment contracts, however, are permissible under the Individual Retirement Annuity option. An endowment contract will not be allowed if:

- (i) Such contract matures later than the taxable year of the individual in whose name the contract is purchased attains the age of 70½;
- (ii) Such contract is not for the exclusive benefit of such individual or his beneficiaries;
- (iii) Such contract does not provide that such individual shall notify the issuer in the event that the aggregate annual premiums due under all such contracts purchased in his name, whether or not such contracts are purchased from the same issuer, exceed \$1,500;
- (iv) Premiums under such contract may increase over the term of the contract;
- (v) The cash value of such contract at maturity is less than the death benefit payable under the contract at any time before maturity;
- (vi) The death benefit does not, at some time before maturity, exceed the greater of the cash value of the sum of premiums paid under the contract;
- (vii) Such contract does not provide for a cash value;
- (viii) Such contract provides that the life insurance element of such contract may increase over the term of such contract, unless such increase is merely because such contract, provides for the purchase of additional benefits; or
- (ix) Such contract provides insurance other than life insurance and waiver of premiums upon disability.<sup>121</sup>

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<sup>118</sup> Proposed Treas. Reg. § 1.408-3(e)(2), 40 Fed. Reg. 7670 (1975). See also IRC § 101(a).

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> Proposed Treas. Reg. § 1.408-3(e), 40 Fed. Reg. 7670 (1975).

While an Individual Retirement Annuity would be advantageous for an individual who wishes to combine insurance protection with retirement savings, there are some disadvantages vis-a-vis the IRA. Insurance companies typically charge a service fee for setting up the annuities, whereas most banks do not charge for establishing IRA's. In addition, the rate of return on annuities is less than that on IRA's.

#### V. PROVISIONS UNIQUE TO INDIVIDUAL RETIREMENT BONDS

The third option available under the Individual Retirement Savings Plan is retirement bonds issued by the federal government under the Second Liberty Bond Act. The purchase price of these bonds is deductible under IRC §§ 219 and 220 as long as they are not redeemed within 12 months of issuance.<sup>122</sup> Upon redemption of the retirement bond, the entire proceeds are included in the taxpayer's gross income unless this amount is rolled over into an IRA, IRAN, or qualified pension plan.<sup>123</sup> In addition, if the bond has not been redeemed by the registered owner before the close of the taxable year in which he reaches 70½, the taxpayer must include as gross income the amount of the proceeds he would have received had he redeemed the bond at this age.<sup>124</sup> When this procedure is followed, the taxpayer need not include as gross income, in the year of actual redemption, any part of the amount received which was taxed in the year the participant turned 70½; only that portion not previously taxed is included.<sup>125</sup>

Rather than redeeming the bond, the taxpayer may choose to surrender it for reissuance. If this is done and the bond is reissued in the same or a lesser face amount, the difference between the current redemption value of the bond surrendered and the current surrender value of the bond reissued is excludable from gross income.<sup>126</sup>

As with IRA's the owner's basis in an Individual Retirement Bond is zero; for this reason the entire redemption pro-

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<sup>122</sup> IRC § 409. If a retirement bond is redeemed within 12 months after the issue date, the proceeds are not included in gross income unless a deduction under IRC §§ 219(a)(3) and 220(a)(3) as amended was taken because of the bond's purchase. *Id.*

<sup>123</sup> Fischer & Berger, *supra* note 18. Of course, the same 60 day limitation applies.

<sup>124</sup> Proposed Treas. Reg. § 1.409-1(b)(1), 40 Fed. Reg. 7671 (1975).

<sup>125</sup> Proposed Treas. Reg. § 1.409-1(b)(2)(i), 40 Fed. Reg. 7671 (1975).

<sup>126</sup> Proposed Treas. Reg. § 1.409-1(b)(2)(iv), 40 Fed. Reg. 7671 (1975).

ceeds are included as part of gross income.<sup>127</sup> Moreover, these nontransferable bonds pay interest only upon redemption and cease to accumulate interest if they are still outstanding when the registered owner attains age 70½ or 5 years after the registered owner's death, but no later than the date on which he would have become 70½.<sup>128</sup> Finally, unless the taxpayer-owner becomes disabled, redemption before age 59½ creates the same 10 percent penalty incurred with premature distribution of IRA's and IRAN's.<sup>129</sup>

In addition to the IRS, the Fiscal Service under the Department of the Treasury also regulates these bonds. This service has issued regulations specifically addressed to the actual issuance of "United States Individual Retirement bonds."<sup>130</sup>

The bonds are issued at par in denominations of \$50, \$100, \$500 and yield 6 percent interest with no interest to be paid on bonds redeemed within 12 months of issuance.<sup>131</sup> Interest will

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<sup>127</sup> Proposed Treas. Reg. § 1.409-1(b)(3), 40 Fed. Reg. 7671 (1975).

<sup>128</sup> IRC § 409(a)(3)(A)(B). See also Fiscal Service, Treas. Reg., 31 C.F.R. § 346.1(b)(1976).

<sup>129</sup> Proposed Treas. Reg. § 1.409-1(d)(1)(2), 40 Fed. Reg. 7671 (1975). Just as many of the restrictions on bonds are the same as those on IRA's and IRAN's, so too are the advantages similar. They allow "larger amounts of principal to be invested for the individual's benefit at higher effective rates than is possible through investment of after-tax dollars on taxable investments . . . the length of the deferral period is a major factor in this greater accumulation potential." Fischer & Berger, *supra* note 18, at 216. In addition, bonds are also advantageous to the federal government because they are stable, long-term debt instruments which are non-inflationary when held by private individuals. Hall, *supra* note 3, at 464.

<sup>130</sup> Fiscal Service, Treas. Regs., 31 C.F.R. §§ 346.0-346.15 (1976). Fiscal Service, Treas. Regs., 31 C.F.R. § 346.3(a) (1976) states:

Individual Retirement Bonds may be purchased over-the-counter or by mail from Federal Reserve Banks and Branches and the Bureau of Public Debt, Securities Transactions Branch, Washington D.C. . . . Customers of commercial banks and trust companies, may be able to arrange for the purchase of the bonds through such institutions, but only the Federal Reserve Banks and Branches and the Department of the Treasury itself, are authorized to issue the securities.

<sup>131</sup> Fiscal Service, Treas. Reg., 31 C.F.R. § 346.1(c)(1976). Just because the taxpayer purchases a bond with the denomination of \$500, however, does not mean that it must be redeemed for that amount. Fiscal Service, Treas. Reg. 31 C.F.R. § 346.8(e)(1976) provides:

[A]n Individual Retirement Bond is a denomination greater than \$50 (face value), which is otherwise eligible for redemption, may be redeemed in part, at current redemption value, upon the request of the registered owner (or a person recognized as entitled to act on his behalf), but only in amounts corresponding to authorized denominations . . . Upon partial redemption



accrue until the bonds are redeemed or have reached maturity, whichever is earlier. Thus, the investment yield of these bonds is likely to be lower than that of an Individual Retirement Account which can be invested at  $6\frac{1}{4}$  to  $7\frac{1}{2}$  percent in high-yielding certificates of deposit and still pay interest even though the IRA funds are withdrawn in less than 12 months. This is true as long as the minimum age of  $59\frac{1}{2}$  has been attained by the account owner.<sup>132</sup>

Since designation of secondary or contingent beneficiaries is prohibited,<sup>133</sup> the regulations also set forth an order of precedence to be followed in distributing bond proceeds. This order also applies when the bond owner dies without a designated beneficiary before the bond is surrendered for payment.<sup>134</sup> The duly appointed executor or administrator of the owner's estate has first priority in the order of distribution;<sup>135</sup> presumably this person would be bound to follow the provisions of the will or the state law of descent and distribution. If, however, no executor or administrator has been or will be appointed, the possibility of deviation from the bond owner's actual intent regarding distribution is very real. This is especially true if the owner designated a beneficiary who had the misfortune of predeceasing him. The remaining order of precedence, however, appears

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of the bonds, the remainder will be reissued as of the original issue date. No partial redemption of a bond will be made after the death of the owner in whose name it is registered.

<sup>132</sup> Fed. Reserve Reg. Q. and FDIC Reg. 329, *supra* note 100. At issuance, the issuing agent enters the issue date on the bond. This is the first day of the month in which the purchase price is received by the authorized issuing agent and determines the date from which interest accrues. The bond is valid only if an authorized issuing agent receives payment, inscribes, dates, stamps, and delivers it. Fiscal Service, Treas. Reg., 31 C.F.R. § 346.1(c) (1976).

<sup>133</sup> A bond may be registered either in single ownership or beneficiary form. Only one beneficiary can be designated on a bond. Fiscal Service, Treas. Reg., 31 C.F.R. § 346.2(a)(1976). In addition, the bond owner can add a beneficiary to a single ownership bond or eliminate or substitute a beneficiary in the case of a bond already registered in beneficiary form. This can be done even without the consent of the beneficiary whose name is removed. Fiscal Service, Treas. Reg., 31 C.F.R. § 346.10a (1976). The bond is then reissued in the new form unless the owner dies after the bond is surrendered for reissue, but before the new bond is issued. If this occurs, the requested change is ineffective as long as the governmental agency which received the request for reissue (either the Federal Reserve Bank or the Bureau of the Public Debt) receives notice of the bondholder's death in sufficient time to withhold delivery of the reissued bond. *Id.*

<sup>134</sup> Fiscal Service, Treas. Reg., 31 C.F.R. § 346.9(a)(1976).

<sup>135</sup> *Id.*

to focus on those who would normally be the natural objects of the bond owner's bounty. If there is and will be no legal representation of the deceased owner's estate, distribution is made to his (her) widow or widower.<sup>136</sup> Failing this, the money goes to the children and the descendants of the deceased children by representation;<sup>137</sup> if none, to the parent(s) of the owner.<sup>138</sup> If all else fails, distribution is made to the owner's next of kin as determined by the laws of the owner's domicile at the time of death.<sup>139</sup>

The same restrictions on alienability, pledging the bond as collateral, and deductibility of contributions imposed on IRA's and IRAN's also apply to bonds.<sup>140</sup> In addition, "[n]o designation of an attorney, agent, or other representative to request payment or reissue on behalf of the owner, beneficiary or other person entitled under § 346.9, other than those as provided in these regulations, will be recognized."<sup>141</sup>

Moreover, because these bonds are issued by the United States, additional regulations have been set forth protecting the interest of the government. The Secretary of the Treasury can reject any application for the purchase of bonds or refuse issuance in any "class or classes of cases if he deems such actions to be in the public interest."<sup>142</sup> The "public interest," however, is not defined; conceivably the Secretary could refuse anyone's application. The Secretary can also require whatever additional evidence he thinks is necessary and may even require a bond of indemnity, with or without surety, where he

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<sup>136</sup> Fiscal Service, Treas. Reg., 31 C.F.R. § 346.9(a)(2) (1976).

<sup>137</sup> Fiscal Service, Treas. Reg., 31 C.F.R. § 346.9(a)(3) (1976).

<sup>138</sup> Fiscal Service, Treas. Reg., 31 C.F.R. § 346.9(a)(4) (1976).

<sup>139</sup> Fiscal Service, Treas. Reg., 31 C.F.R. § 346.9(a)(5) (1976). If the bond owner dies before redemption but with a surviving beneficiary who fails to present the bond for payment during his life, payment is made in a similar fashion but to the legal representative, surviving spouse, etc. of the beneficiary, not the original owner. Fiscal Service, Treas. Reg., 31 C.F.R. § 346.9(b)(2) (1976).

<sup>140</sup> Fiscal Service, Treas. Reg., 31 C.F.R. §§ 346.6, 346.7 (1976). Involuntary transfers (e.g., levy and execution on a judgment) will be recognized only if the bond in question has become eligible for redemption pursuant to the regulations. *Id.* Apparently this means that once the bondholder has attained the age of 59½ and is thus entitled to redeem his bond, a creditor could levy on that bond.

<sup>141</sup> Fiscal Service, Treas. Reg., 31 C.F.R. § 346.11 (1976).

<sup>142</sup> Fiscal Service, Treas. Reg., 31 C.F.R. § 346.15(b) (1976). The regulation further states that the Secretary's action is to be final.

considers this necessary for the protection of the United States.<sup>143</sup>

## VI. CUSTODIAL RESPONSIBILITY IN ADMINISTERING IRSP'S

In addition to prescribing the conduct of participants, the regulations also contain a host of provisions outlining the responsibilities of the custodian or trustee of IRA's and IRAN's. Initially, custodians must submit an annual report to the IRS Commissioner and to the individual on whose behalf the plan is established. These reports must include the amount contributed to the account or annuity, and any other information required by the form issued by the IRS. In addition, the custodian of an endowment contract must specify the amount of premium allocable to retirement savings.<sup>144</sup> A separate report must be filed for each IRA or annuity maintained<sup>145</sup> and must be filed on or before the 30th day of the first month following the close of the individual's taxable year.<sup>146</sup>

Recent temporary regulations also impose disclosure requirements upon the issuer and custodian or trustee of an IRA and the issuer of an endowment contract or annuity.<sup>147</sup> A disclosure statement and a copy of the instrument establishing the account, contract, or annuity must be furnished to the participant not later than 7 days preceding the date on which it is established. If this individual is permitted to revoke the plan

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<sup>143</sup> Fiscal Service, Treas. Reg., 31 C.F.R. § 346.15(c) (1976), which states that these bonds are also subject to the general regulations regarding United States securities. These regulations are prescribed by the Secretary of the Treasury and are set forth in Department of the Treasury Circular No. 300. The Secretary, however, may waive or modify any provisions of this circular in any particular case or class of cases for the convenience of the United States or in order to relieve any person or persons of unnecessary hardship, if such action is not inconsistent with the law, does not impair any existing rights, and he is satisfied that such action would not subject the United States to any substantial expense or liability. Fiscal Service, Treas. Reg., 31 C.F.R. § 346.15(d) (1976).

For other provisions concerning requests for payments, certifying officers, or lost, stolen or destroyed bonds see Fiscal Service, Treas. Regs., 31 C.F.R. §§ 346.8(d), 346.14, 346.12 (1976).

<sup>144</sup> Proposed Treas. Reg. § 1.408-1(d)(1), Fed. Reg. 7668 (1975).

<sup>145</sup> When accounts are established by employers or certain employee associations, there must be a separate account for the interest of each employee or member. Proposed Treas. Reg. § 1.408-2(c)(3), 40 Fed. Reg. 7669 (1975).

<sup>146</sup> Proposed Treas. Reg. § 1.408-1(d)(2), 40 Fed. Reg. 7668 (1975).

<sup>147</sup> Temporary Treas. Reg. § 11.408(i)-1, 40 Fed. Reg. 51636 (1975).

within a minimum of 7 days after establishment, however, the disclosure statement can be submitted on the establishment date. If the disclosure statement relates only to an amendment to the plan, it need not be furnished until 30 days after the date on which the amendment becomes effective or the date of adoption.

This disclosure statement must include the following in non-technical language:

- (1) Concise explanations of the requirements imposed by section 408(a) on IRA's and section 408(b) on IRAN's and the limitations and restrictions on the deduction for retirement savings imposed by section 219;<sup>148</sup>
- (2) Statements describing the statutory prohibitions against engaging in prohibited transactions;<sup>149</sup>
- (3) An explanation that further information may be obtained from the Internal Revenue Service;<sup>150</sup>
- (4) A statement that IRC § 2039, which exempts certain annuities from estate tax, does not apply to Individual Retirement Accounts, Annuities, or endowment contracts described in section 408(b) (IRAN);<sup>151</sup> and
- (5) A similar statement that IRC § 402(c), authorizing a deduction for the ordinary income portion of a lump sum distribution under certain conditions, does not apply to IRA's, IRAN's or endowments described by section 408(b).<sup>152</sup>

With amended plans, however, the disclosure statement need explain only those matters affected by the amendment.<sup>153</sup> In addition, if the plan either guarantees an amount over a period of time or a projection of the plan's growth can be reasonably made, the statement must include a description of the amount of money that would be available to the benefited individual if the purchaser made level annual contributions of an assured amount and withdrew the account, annuity, or endowment contract at the end of the first 5 years during which contribu-

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<sup>148</sup> Temporary Treas. Reg. § 11.408(i)-1(c)(1)(i), 40 Fed. Reg. 51636 (1975).

<sup>149</sup> See generally Temporary Treas. Reg. 11.408(i)-1(c)(2)(i) to (vii), 40 Fed. Reg. 51636 (1975).

<sup>150</sup> Temporary Treas. Reg. 11.408(i)-1(c)(2)(ix), 40 Fed. Reg. 51636 (1975).

<sup>151</sup> Temporary Treas. Reg. 11.408(i)-1(c)(2)(v), 40 Fed. Reg. 51636 (1975). The 1976 Tax Reform Act has changed this. IRSP's providing for annuity-type payouts may be excludible from a decedent's gross estate. See n. 167, *infra*.

<sup>152</sup> Temporary Treas. Reg. § 11.408(i)-1(c)(2)(vi), 40 Fed. Reg. 51636 (1975).

<sup>153</sup> Temporary Treas. Reg. § 11.408(i)-1(d)(ix), 40 Fed. Reg. 51636 (1975).

tions were made and at the end of each of the years in which the purchaser reached the age of 60, 65, or 70.<sup>154</sup>

While these disclosure requirements make the individual participant more clearly aware of the numerous restrictions placed on IRA's and IRAN's, they also increase the costs of administration. Eventually this may force custodians and trustees to charge "starting fees."

There are additional responsibilities imposed on the institution or individual setting up an Individual Retirement Account. Initially, one must decide whether the IRA should be set up as a custodial account or a domestic trust.<sup>155</sup> This choice, however, is not clearly delineated in the statute; "custodial account" is never defined but, for the purposes of the statute authorizing IRA's, is treated as a trust created for the exclusive benefit of the individual or his beneficiaries.<sup>156</sup>

The regulations stipulate, however, that a custodial account shall be treated as a trust if the assets of the account are held by a bank or another person who demonstrates that the account will be administered according to the requirements of section 408.<sup>157</sup> Unfortunately, the statute does not explain what is meant by treating the account as a trust. If it means that establishing an IRA creates a fiduciary relationship between the participant and the custodian, a duty may be imposed on the custodian to police the amount of the contribution and insure compliance with the law rather than leaving this up to the individual and IRS.<sup>158</sup> If a custodial account is treated as a

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<sup>154</sup> Temporary Treas. Reg. § 11.408(i)-1(e)(i), 40 Fed. Reg. 51636 (1975).

<sup>155</sup> IRC § 408.

<sup>156</sup> See Proposed Treas. Reg. § 1.408-2(b)(8), 40 Fed. Reg. 7669 (1975). "Beneficiaries" include the individual's estate, dependents, and any person designated to share in the benefits of the account after the death of the individual.

<sup>157</sup> Proposed Treas. Reg. § 1.408-2(b)(2), 40 Fed. Reg. 7668 (1975).

<sup>158</sup> The responsibility of the custodian for checking is unclear. Louisville Trust feels that if monthly payments are made to the IRA, the responsibility for policing them lies on the customer with the custodian bank making sure that the customer knows the regulations and indicates his knowledge by signing the agreement. Interview with Kennedy Clark, *supra* note 57. The American Banking Association asserts that the bank only has to return the excess when requested to do so by the individual. AMERICAN BANKING ASS'N., *supra* note 3, at 15.

The statutory language, however, indicates that the custodian has more responsibility than merely checking: No contribution is to be accepted unless it is in cash; contributions "will not be accepted for the taxable year in excess of \$1500 on behalf of any individual." IRC § 408(a)(1).

trust, the difference between the trust and an account is unclear.<sup>159</sup>

Custodians or trustees must also be sure that the accounts themselves meet required standards. All IRA's must be evidenced by a written document. To do this the bank may choose to use the custodial account forms established by the IRS along with additional provisions<sup>160</sup> or it may choose to establish its own master plan.<sup>161</sup> Regardless of the decision, the *trust instrument* must provide that:

- (1) The IRA is formed for the exclusive benefit of the individual and his beneficiaries;
- (2) all contributions, except rollovers, must be in cash and cannot exceed \$1,500 per year;
- (3) the individual's interest in the account must be, or commence to be, distributed by the end of the year in which he reaches 70½;
- (4) no part of the trust funds are to be invested in life insurance contracts;
- (5) no assets can be commingled with property other than a common trust fund;
- (6) the interest of the individual will be distributed to him either in a lump sum distribution or one of the four annuity options;

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<sup>159</sup> One large Louisville bank has simply ignored the trust option and is simply setting up accounts in the form of open-ended time deposits. Interview with Kennedy Clark, *supra* note 57.

<sup>160</sup> Counsel for Louisville Trust Bank recommended to that bank that the following additional clauses be inserted: "Contributions will be deposited in a savings account subject to applicable rules and regulations of the custodian as from time to time in effect." "Subject to all requirements under [section] 408(a) of the Internal Revenue Code." Interview with Leland Hulbert, Vice President, Louisville Trust Bank, June 20, 1975.

<sup>161</sup> If a bank draws up its own master plan, it can request an opinion letter from the IRS regarding the eligibility of its prototype plan for tax favored treatment. Rev. Proc. 75-6, § 3.02(2), 1975-1 CUM. BULL. 647; AMERICAN BANKING ASS'N. *supra* note 3, at appendix. A favorable determination letter is not required for obtaining IRA (or any other IRSP) benefits, but would be a good way for a prudent bank to minimize potential liability. Rev. Proc. 75-6, § 2.02, 1975-1 CUM. BULL. 647.

Insurance companies can also request an opinion letter as to whether their prototype IRAN plans meet the requirements of IRC § 408(b). Rev. Proc. 75-6, § 3.02(2), 1975-1 CUM. BULL. 647. Each opinion letter will bear an identifying serial number assigned to the prototype trust, custodial account, or contract. *Id.* The IRS, however, will not issue such letters to individual owners of IRA's or IRAN's. Rev. Proc. 75-6, § 3.01 (1), 1975-1 CUM. BULL. 647.

(7) when an individual to benefit under the trust dies before his entire interest has been distributed (or if distribution has been commenced to the surviving spouse who dies before total distribution) one has 5 years from death to distribute the entire interest or apply it to the purchase of an annuity for the beneficiary or beneficiaries which will be payable for the life of such beneficiary or for a term certain not exceeding his life expectancy.<sup>162</sup>

Custodial liability for non-compliance can be minimized by using the Internal Revenue Service's prototype; this includes all required provisions. In addition this prototype provides flexibility because IRS approval is not required for use of this form or for its use in conjunction with additional information.

## VII. CONCLUSION: IS THE IRSP WORTH IT?

Despite the favorable tax treatment granted to IRSP participants, the thicket of restrictions may conceivably outweigh the relatively modest annual deductions allowed for IRSP contributions. Kentuckians not only have to weigh these restrictions against modest federal deductions but must also consider the lack of state deductions. Because the legislature must formally incorporate all changes in the federal income tax law into Kentucky tax law, Kentuckians participating in IRSP's will not be permitted a deduction for their contributions on their 1976 state income tax.<sup>163</sup>

Moreover, the 6 percent tax imposed on excess contributions could be inequitable because it is imposed regardless of intent to violate the rule. Such inequitable treatment could be avoided if a stiffer penalty were imposed on those making will-

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<sup>162</sup> Proposed Treas. Reg. § 1.408-2(b)(1-8), 40 Fed. Reg. 7668-7669 (1975). For this purpose the custodial account is also treated as a trust. Proposed Treas. Reg. § 1.408-2(e), 40 Fed. Reg. 7669 (1975). The annuity contracts are immediately distributed to the beneficiary. In addition, amounts distributed under such contracts are taxable. Proposed Treas. Reg. § 1.408-2(b)(7), 40 Fed. Reg. 7669 (1975).

<sup>163</sup> This hiatus occurred because the legislature did not meet in 1975 and was thus unable to incorporate the IRSP deduction to make it applicable to this year's taxpayers.

ful excess contributions. In addition, as one commentator asserts, establishment of the 10 percent penalty tax for premature distributions discriminates against IRSP participants; qualified plans are not required to contain such restrictions, and in Keogh Plans, premature distributions restriction applies only to owner-employees.<sup>164</sup> The multiplicity of rules and regulations, and the degree of frugality required to comply might also discourage lower and middle income groups—the very groups who most need pension planning.<sup>165</sup> Furthermore, efficient administration of the Act might be impossible to achieve because there is a tripartite scheme of enforcement with the regulatory provisions administered by the Secretary of Labor, the tax provisions administered by the Secretary of the Treasury, and insurance provisions administered by the Pension Benefit Guaranty Corporation.<sup>166</sup>

Perhaps the biggest drawback to IRSP's, however, is that they are not necessarily the best method of estate planning; they have no special federal estate and gift tax rules.<sup>167</sup> If an

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<sup>164</sup> Fischer & Berger, *supra* note 18, at 218. See also CCH Explanation of § 401, 3 CCH 1976 STAND. FED. TAX REPORTER ¶ 2613.25.

But the explanation at ¶ 2613.25 also states, "unless permanently disabled no owner-employee or self-employed person in a plan may withdraw money from it until he is at least 59 ½ years old." This statement indicates that the prohibition may apply to all self-employed persons participating in the plan whether they are owner-employees or not.

<sup>165</sup> Hall, *supra* note 3, at 465.

<sup>166</sup> There are, however, "pious exhortations contained in the Act requesting the Secretary of the Treasury and the Secretary of Labor to consult with each other so as not to mess up the administration of the Act any more than necessary." Overback, *Persons Upon Whom Duties and Obligations are Imposed Under the Employee Retirement Income Security Act of 1974*, 52 TAXES 881, 892 (1974).

<sup>167</sup> This discriminates against IRA participants in that certain amounts in qualified corporate plans are exempt from estate and gift taxes. See Fischer & Berger, *supra* note 18, at 218.

The 1976 Tax Reform Act, however, eliminates this inequity. The value of an annuity receivable by a beneficiary (other than the creator of the IRSP) under an individual retirement account, annuity or bond is *excluded* from the value of the decedent creator's estate. IRC § 2039(e). To qualify for this exclusion, distributions are not required to be in the form of a commercial annuity. CCH Explanation, CCH STAND. FED. TAX REP. Tax Reform Act of 1976 ¶433. A series of "substantially equal periodic payments" over the life of the beneficiary or over a period of at least 36 months will satisfy the exclusion requirements. IRC § 2039(e).

This exclusion, however, does not extend to lump sum distributions, whether from IRSP's or from qualified plans. CCH Explanation, CCH STAND. FED. TAX REP. Tax Reform Act of 1976 ¶433 for IRSP's; IRC § 2039(c) *as amended* for qualified plans.



individual dies before all of the assets in his plan have been distributed or dies before attaining the minimum required age of 59½, the date of death value of the IRA, the balance in the account at date of death, including contributions and accrued interest, is includible in his gross estate;<sup>168</sup> also, if there is no named beneficiary the estate incurs income tax on IRSP assets.

If there is a named beneficiary, however, there is no income tax imposed on the estate for IRA assets; the assets go directly to the beneficiary or beneficiaries.<sup>169</sup> Because the distribution is made to the named beneficiary, the interest is taxable to him. It is unclear, however, whether the principal is also taxable to him; normally property acquired through bequest or inheritance is not taxable to the recipient. This type of distribution must be made in a lump sum or applied to the purchase of an immediate annuity for the beneficiary or beneficiaries (or the beneficiary or beneficiaries of this surviving spouse) within 5 years after death.

Finally, qualified plan participants still enjoy more favorable tax treatment: capital gains treatment for lump sum distributions, 10 year income averaging, and lower income tax liability for distributions to the extent that qualified plan participants are permitted to include their contributions as part of their basis in the plan.

Despite the disadvantages inherent in IRSP's and despite the still-favored tax treatment given qualified plan participants, however, the fact still remains that "... those lower and middle income taxpayers who have for so long been paying with their taxes for more affluent people's pensions will now for the first time have the opportunity, if they have the will, to achieve comparable tax benefits for themselves while providing funds for their own retirement."<sup>170</sup>

*Carol M. Lambert*

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<sup>168</sup> IRC § 408(d)(1).

<sup>169</sup> Interview with Kennedy Clark, Trust Officer, Louisville Trust, July 19, 1975. There is some debate as to the correctness of this interpretation: Did the drafters intend to give IRA's more favorable tax treatment than other investments, such as government bonds? The value of bonds is included in the gross estate.

<sup>170</sup> Hall, *supra* note 3, at 465.